Rising inequality in the Eurozone underlines the need for a fiscal union

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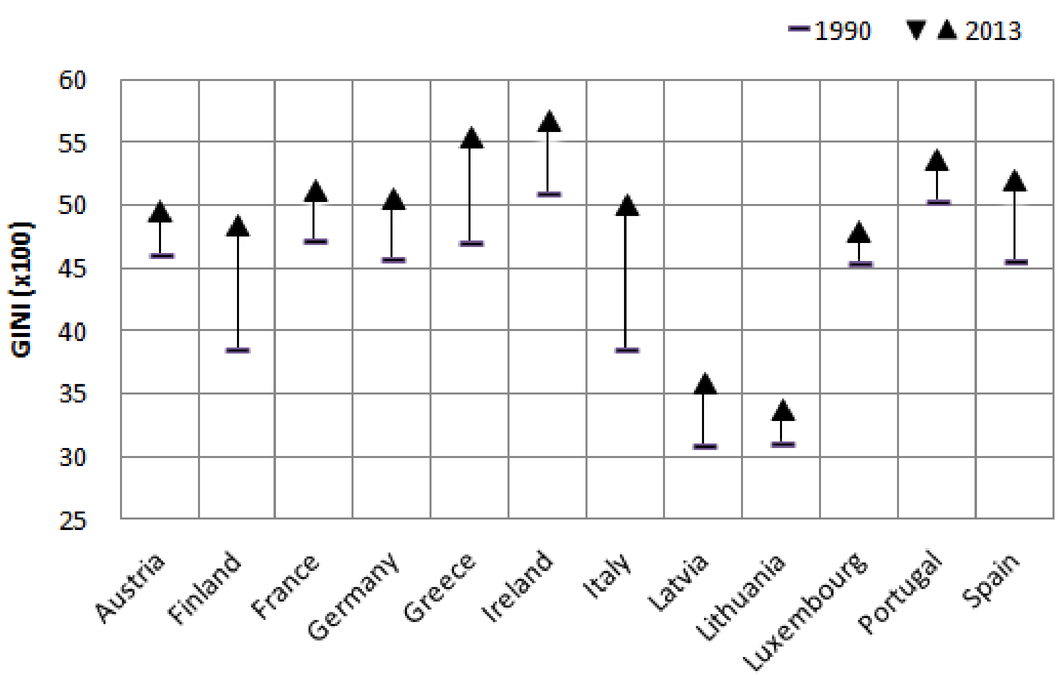
How has inequality within Eurozone states changed during the pursuit of Economic and Monetary Union? **Dawid Sawicki** *writes that in the majority of Eurozone members income inequality has increased substantially since 1990. He argues that this is partly the result of a lack of automatic stabilisers within the Eurozone that can compensate for economic shocks, and that the increase in inequality presents a compelling case for a genuine fiscal union between those countries using the single currency.*

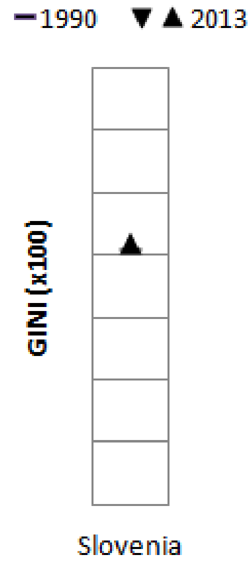
The European Commission identifies income inequality as one of the key catalysts of social exclusion. It argues that widespread disparities hinder the achievement of the EU's strategic goals of sustained economic growth, more and better jobs, and greater social cohesion.

Although the European Council has devised multiple strategies aimed at decreasing inequality, including the Lisbon Agenda and Europe 2020, income gaps have actually increased over the past 25 years in the majority of Eurozone countries, as shown in Figure 1 below. Currently, one in six people in Europe lives below the poverty threshold. Moreover, over seventeen million Europeans live on less than 5 euros per day. This poses a challenge for policymakers as the need to satisfy both ends of the polarised income distribution impedes the design of meaningful reforms.

Figure 1: Changes in income inequality as measured by the Gini coefficient between 1990 and 2013

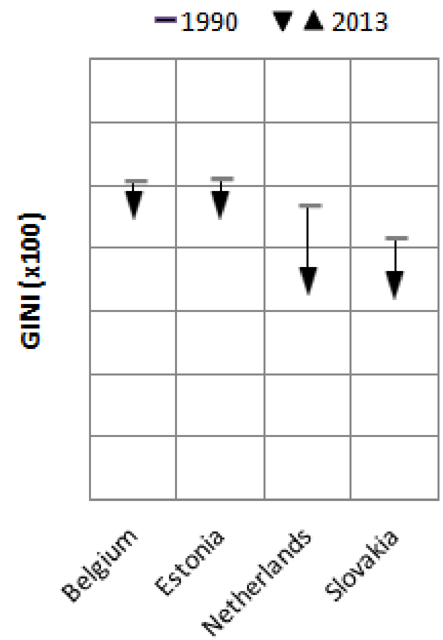
- Increasing inequality
- Similar inequality
- Decreasing inequality





***Note:* The charts show how income inequality (before taxes and transfers) has changed since 1990. The 1990 value for each country is shown by the horizontal line, with the 2013 value indicated by the arrows. *Source:* Luxembourg income study.**

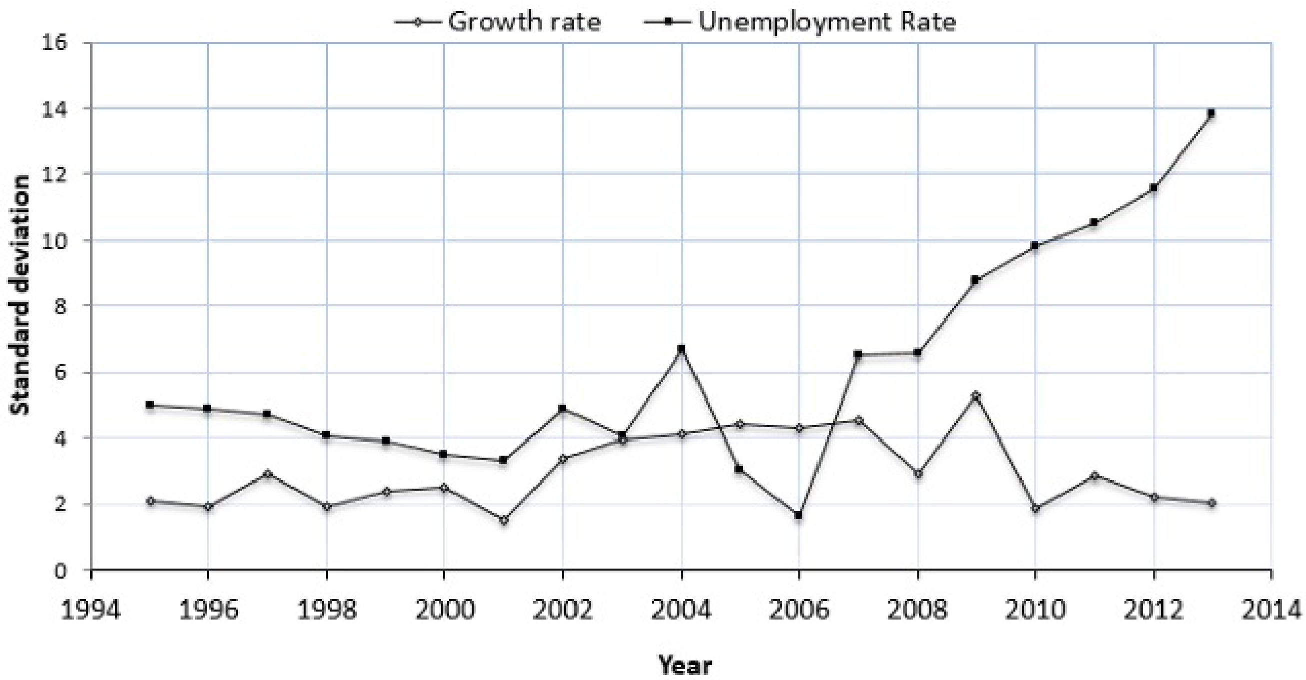
The period shown in Figure 1 coincided with the development of Economic and Monetary Union (EMU), but how has this integration process affected inequality? There were three key stages in EMU: the signing of the Maastricht Treaty in 1992, the agreement of the Stability and Growth Pact in the late 1990s, and finally the adoption of the euro as a common currency for those states in the Eurozone. Using a regression analysis, a statistically significant link is apparent between states signing the Stability and Growth Pact/adopting the euro and experiencing an increase in income inequality.



The reasons for this finding are more difficult to pinpoint. When those states in the Eurozone adopted the euro as their currency, they tied their hands to a common monetary policy determined by the European Central Bank. Despite being united in terms of monetary policy, however, states have maintained the ability to pursue independent fiscal policies. This has generated some notable problems, most recently during the Eurozone debt crisis. It is also an open question as to whether each member of the Eurozone made the correct decision in adopting the common currency in the first instance.

According to Robert Mundell, symmetry of economic shocks should be one of the most important pillars of a monetary union. Unfortunately, the economies of the Eurozone have experienced fundamentally asymmetric shocks, as shown in Figure 2 below.

Figure 2: Standard deviation of unemployment and growth rates in the Eurozone (1995-2013)



***Note:* The chart illustrates the divergence in unemployment and growth rates among Eurozone members. *Source:* Author's own calculations based on Eurostat data.**

This has forced the ECB to tailor its monetary policy to satisfy country-specific needs. As it can only accomplish this to a partial extent, countries have been left to deal with the adverse effects of these shocks. However this has proved too much to ask.

Successful monetary unions, such as those in the United States or Canada, have automatic stabilisers to help in times of asymmetric shocks. One such stabiliser is labour mobility. If workers in Pennsylvania lose their jobs as a result of a shock to the local economy, they can easily migrate to another state in search of employment. In the Eurozone, although individuals have the legal right to move to another state, there are barriers in terms of language and culture which inhibit this.

The lack of these stabilisers has created a situation in which the adoption of the common currency has the put the social cohesion of European states at risk. When a member of the Eurozone suffers an economic shock it cannot rely on monetary policy for adjustment. However the state's citizens cannot rely on uninhibited labour mobility either, which generates unemployment and increases income inequality.

Fiscal union as a way forward

Labour mobility is not, however, the only insurance mechanism available to members of a monetary union. Perhaps the only real way forward for states in the Eurozone is the creation of a genuine fiscal union, encompassing a supranational body at the EU level with responsibility for fiscal policy.

In the context of rising inequality a supranational fiscal body would exist to ensure that effective transfers of income between countries can compensate for asymmetric shocks. This solution entails creating a community-wide system of taxes and transfers, acting as an automatic stabiliser when necessary. For instance, if the German automotive industry is hit by an adverse shock, the country would automatically receive funds from the common budget, cushioning it from an increase in income inequality.

This is, of course, a deeply controversial solution, implying as it does the creation of something approximating a

‘United States of Europe’. However there is no reason to believe that the Eurozone can function effectively without the coordination of monetary and fiscal policies – just as national economies required internal co-ordination to function effectively prior to Economic and Monetary Union.

This is not to say that the implementation of a genuine fiscal union will not entail challenges. One such challenge is the fact that coordinating monetary and fiscal policies at the supranational level will result in the loss of political independence. Cultural differences could also impact upon the functioning of a supranational fiscal body, with variations existing, for instance, in terms of the effectiveness of tax collection or the retirement age in Eurozone states. As such national governments would still be afforded a key role in facilitating the process of political integration, given national authorities will have a keener appreciation of country-specific needs than supranational actors.

The principle that income inequality has increased in Eurozone countries partly as a result of the integration process is striking, but rather than offering an argument against the concept of Economic and Monetary Union, it underlines the need for genuine fiscal coordination in the European context. Ultimately it serves as another example that further political integration is what the Eurozone really needs.

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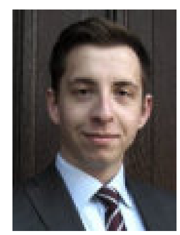
Dawid Sawicki has an MA (Hons) degree in Economics from the University of St Andrews. His research interests include European integration, applied econometrics, economic development and reform.



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